

Message Text

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PAGE 01 LONDON 19649 01 OF 03 020117Z
ACTION EUR-12

INFO OCT-01 EA-10 IO-13 ISO-00 FRB-03 AID-05 CIAE-00
EB-08 INR-07 NSAE-00 USIA-06 XMB-02 OPIC-03 SP-02
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R 011814Z DEC 77
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TO SECSTATE WASHDC 0880
TREASURY DEPT WASHDC
INFO AMEMBASSY BONN
AMEMBASSY BRUSSELS
AMEMBASSY DUBLIN
AMEMBASSY PARIS
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LIMITED OFFICIAL USE SECTION 01 OF 03 LONDON 19649

USEEC ALSO FOR EMBASSY
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DEPARTMENT PASS FEDERAL RESERVE BOARD; TREASURY FOR
DONALD E. SYVRUD, OASIA

E.O. 11652: N/A
TAGS: ECON, UK
SUBJECT: NIESR CRITICIZES ECONOMIC POLICIES

SUMMARY: IN A TWO-FISTED ATTACK ON CURRENT HMG MACRO-
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PAGE 02 LONDON 19649 01 OF 03 020117Z

ECONOMIC POLICY, THE NATIONAL INSTITUTE OF ECONOMIC AND
SOCIAL RESEARCH (NIESR) PLEADS FOR A SUSTAINED REFLATION
OF THE BRITISH ECONOMY. IN ITS LATEST QUARTERLY REVIEW,
NIESR ADVOCATES A POLICY OF FISCAL STIMULUS, EFFECTIVE
WAGE RESTRAINT, AND AN EXCHANGE RATE MANAGED TO PROMOTE
STEADY GROWTH IN NON-OIL EXPORTS. THE MONETARY CONSE-
QUENCES OF THIS PRESCRIPTION ARE MINIMIZED. UNLIKE ITS

PRESCRIPTION, NIESR'S 1978 FORECAST IS BASED ON CURRENT POLICIES AND ON AN ASSUMPTION OF A FREELY FLOATING POUND. IT EXPECTS 3.4 PERCENT REAL GROWTH, A CURRENT ACCOUNT SURPLUS OF 2.1 BILLION POUNDS AND A RISE IN CONSUMER PRICES OF 8.4 PERCENT. END SUMMARY.

1. AFTER A YEAR UNDER THE EDITORSHIP OF A CONFIRMED MONETARIST (ITS FIRST) NIESR'S QUARTERLY REVIEW RETURNED TO MORE FAMILIAR IDEOLOGICAL HANDS LAST SUMMER. THE LATEST REVIEW REFLECTS CONCERN FOR THE REAL ECONOMY WHICH IS PERCEIVED TO HAVE BEEN UNDULY INFLUENCED BY THE GOVERNMENT'S ADHERENCE TO RESTRICTIVE FINANCIAL TARGETS.

2. SCORN IS HEAPED ON A FISCAL POLICY WHICH IN THE ABSENCE OF A "SENSIBLE INCOMES POLICY" APPEARS TO BE DETERMINED "PARTLY BY HOPES OF PAY RESTRAINT AND PARTLY BY THE ADOPTION OF LARGELY IRRELEVANT AND SOMETIMES MISLEADING FINANCIAL CRITERIA."

3. WHILE ACCEPTING THAT THE "IMF PRESCRIPTION" OF DECEMBER 1976 LED TO A RECOVERY IN INTERNATIONAL CONFIDENCE AND "PROBABLY ARRESTED THE DECLINE IN THE EXCHANGE RATE," NIESR ATTRIBUTED THE IMPROVEMENT IN THE CURRENT ACCOUNT TO NORTH SEA OIL AND THE SLACKENING OF INFLATION TO PHASE TWO OF THE INCOMES POLICY. IT NOTES THE ABANDONMENT OF THE IMF LETTER OF INTENT COMMITMENT TO MANAGING THE EXCHANGE RATE TO PRESERVE COMPETITIVENESS, THE ONLY LIMITED OFFICIAL USE

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PAGE 03 LONDON 19649 01 OF 03 020117Z

PART OF THE LETTER WITH WHICH IT AGREED.

4. NIESR'S OWN PRESCRIPTION FOR 1978 IS BASED ON THREE ELEMENTS:

- SUSTAINED EXPANSION OF DEMAND STIMULATED BY FISCAL POLICY
- AN EXCHANGE RATE MANAGED TO PROMOTE THE GROWTH OF NET NON-OIL EXPORTS
- AN EFFECTIVE INCOMES POLICY MANAGED BY A PERMANENT SINGLE BODY.

5. THE MONETARY CONSEQUENCES OF SUCH A POLICY ARE TREATED IN A RATHER CAVALIER FASHION. NIESR BELIEVES THAT "THE PURSUIT OF MONEY SUPPLY TARGETS IN A WAY WHICH JEOPARDIZES REAL TARGETS (FOR EXAMPLE, BY OVER-REACTION TO LIMITED DEVIATIONS FROM THE MONETARY GUIDELINES) IS CERTAINLY HARMFUL". MOREOVER NIESR STATES THAT ANY RISE IN THE DOMESTIC MONEY SUPPLY, WHETHER FOREIGN OR DOMESTICALLY CAUSED, WOULD PRODUCE A BENEFICIAL ALTHOUGH SMALL IMPACT ON THE ECONOMY. IF THE MONETARY TARGETS WERE TO BE BREACHED, NIESR ARGUES THAT THE RESULTANT WEAKENING IN INTERNATIONAL CONFIDENCE WOULD CAUSE AN OUTFLOW OF

FOREIGN CAPITAL. THIS BEING THE CASE, ANY CAPITAL FLOW
INDUCED INCREASE IN THE MONEY SUPPLY WOULD BE REVERSED.

6. NIESR TAKES COMFORT IN ITS POLICY PRESCRIPTION FROM
THE RECENT MEETING OF ECONOMISTS AT THE BROOKINGS INSTI-
TUTION (ONE OF THE PARTICIPANTS WAS NIESR'S DIRECTOR

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PAGE 01 LONDON 19649 02 OF 03 020115Z
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LIMITED OFFICIAL USE SECTION 02 OF 03 LONDON 19649

DAVID WORSWICK) WHICH EMPHASIZED THE NEED FOR EXPANSION-
ARY POLICIES BEYOND THE THREE LOCOMOTIVE ECONOMIES.

7. IN BRITAIN'S CASE THAT EXPANSION IS BASED ON THE RE-
SOURCES MADE AVAILABLE FROM THE RISING OIL OUTPUT OF
THE NORTH SEA. IN A FURTHER ANALYSIS OF MEDIUM TERM POLI-
CY OPTIONS, NIESR EXAMINES THREE BROAD CATEGORIES OF

POLICY ALTERNATIVES MADE POSSIBLE BY NORTH SEA OIL AND
GAS. THESE ARE
--THE FINANCIAL OPTIONS
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PAGE 02 LONDON 19649 02 OF 03 020115Z

--EXCHANGE RATE POLICY AND THE CONTROL OF INFLATION
--OUTPUT EMPLOYMENT AND INVESTMENT POLICIES.

THE FIRST BROAD GROUP INCLUDES
--A SUSTAINED CURRENT ACCOUNT SURPLUS MADE POSSIBLE
BY MAINTAINING A LOWER THAN MARKET EX-
CHANGE RATE
--A RELAXATION OF CAPITAL CONTROLS ON OUTWARD
INVESTMENT
--THE REPAYMENT OF FOREIGN DEBT.

NIESR EXAMINES EACH OF THESE AND CONCLUDES THAT "ON
BALANCE THE VARIOUS WAYS IN WHICH THE OIL INDUCED
SURPLUS ON CURRENT ACCOUNT MIGHT BE USEFULLY OFFSET
ON THE CAPITAL ACCOUNT ARE NOT HARMFUL. INDEED THEY PRO-
VIDE A POTENTIAL MEANS OF HOLDING DOWN THE EXCHANGE RATE
AS WELL AS ADDING TO FUTURE NET INCOME. BUT, PROVIDED
MORE BENEFICIAL USES CAN BE FOUND, (ITALICIZED) WE
THINK THEY SHOULD BE GIVEN A RATHER LOW PRIORITY."

8. WITH REGARD TO THE SECOND CATEGORY OF OPTIONS, NIESR
STRONGLY QUESTIONS THE BENEFICIAL EFFECTS OF AN APPRECI-
ATING EXCHANGE RATE. TWO COMPETING MEDIUM TERM (1977-81)
SCENARIOS ARE PRESENTED, ONE BASED ON A FREELY FLOATING
POUND AND THE OTHER ON A RATE MANAGED TO PRESERVE EXPORT
COMPETITIVENESS OF MANUFACTURES FROM 1978 ON. AVERAGE
EARNINGS WERE BASED ON AN AUGMENTED PHILLIPS CURVE WHERE
WAGE INFLATION DEPENDS ON LABOR MARKET DEMAND AND THE
RATE OF PRICE CHANGE.

9. THE FLOATING POUND SCENARIO RESULTED IN HIGHER UN-
EMPLOYMENT, LOWER OUTPUT, INVESTMENT AND INFLATION AND A
DETERIORATING CURRENT ACCOUNT WHILE THE MANAGED EXCHANGE
RATE PRODUCED OPPOSITE RESULTS. NIESR ADMITS THAT THESE
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PAGE 03 LONDON 19649 02 OF 03 020115Z

RESULTS ARE QUITE SENSITIVE TO THE SPECIFICATIONS OF THE

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PAGE 01 LONDON 19649 03 OF 03 020117Z
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LIMITED OFFICIAL USE SECTION 03 OF 03 LONDON 19649

MODEL. NEVERTHELESS, FOR NIESR THE MANAGED EXCHANGE RATE
OPTION IS SUPERIOR SINCE IN ITS VIEW, UK INFLATION WILL
BE DIFFICULT TO BRING DOWN TO OR BELOW ITS COMPETITORS.
THEREFORE, TO ALLOW A SIGNIFICANT SHORT TERM RISE IN
THE EXCHANGE RATE WOULD EXACERBATE THE NECESSARY LONGER
TERM ADJUSTMENT.

10. THE THIRD CATEGORY OPTIONS ARE BASED ON THE NEED TO
REDUCE UNEMPLOYMENT FROM CURRENT LEVELS. IN NIESR'S
VIEW THIS REQUIRES REAL GROWTH OF AT LEAST 3.5 PERCENT A
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PAGE 02 LONDON 19649 03 OF 03 020117Z

YEAR TO ABSORB A LABOR FORCE GROWING AT NEARLY 1 PERCENT
A YEAR AND TO ABSORB THE TREND GROWTH IN PRODUCTIVITY

EVEN AT THE LOW LEVEL, ABOUT 2.5 PERCENT, OF RECENT YEARS. THE GROWTH IN AVERAGE EARNINGS IS CENTRAL TO THE GROWTH IN OUTPUT. NIESR AGAIN PRESENTS TWO SCENARIOS, ONE BASED ON AN INCOMES POLICY WHICH BRINGS THE RATE OF GROWTH OF AVERAGE EARNINGS TO 6 PERCENT BY 1981, AND THE OTHER WHICH ASSUMES AN ANNUAL INCREASE OF 15 PERCENT IN AVERAGE EARNINGS. THE TWO SCENARIOS PRODUCE PREDICTABLE RESULTS WITH THE 15 PERCENT VARIANT PRODUCING RISING INFLATION. A SHRINKING CURRENT ACCOUNT SURPLUS AND A DEPRECIATING EXCHANGE RATE.

11. THUS NIESR CONCLUDES THAT SUSTAINED EXPANSION, INCOMES POLICY AND A MANAGED EXCHANGE RATE ARE THE MOST VIABLE WAY OF BENEFITING FROM NORTH SEA OIL.

12. FURTHER ANALYSIS OF NIESR BASIC FORECAST FOLLOWS SEPTTEL.

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